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POLICY BRIEF
No. 71 • January 2016

ASSESSING THE GOVERNANCE PRACTICES OF SUSTAINABILITY REPORTING

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Key Points

- Sustainability reporting has become an increasingly popular practice among global companies and financial regulators.
- The practices employed to shape sustainability reporting are quite diverse, which limits their capacity to promote sustainable corporate behaviour. But this diversity creates an opportunity to assess the effectiveness of these practices as an emerging form of governance over corporate sustainability.
- Developing criteria to define the governance practices that support effective reporting is a critical step to inform discussions among financial regulators. This is particularly important as the Financial Stability Board (FSB) recently proposed to the Group of Twenty (G20) that a Climate Disclosure Task Force should be created to develop knowledge on efficient and effective disclosure.

Introduction

Mark Carney, the governor of the Bank of England, recently argued that financial markets suffer from a "tragedy of the horizon" (Carney 2015), as the impacts of climate change will occur beyond the policy horizon for financial markets, thus limiting the incentive for regulation that promotes risk mitigation. The FSB recently responded to this concern by proposing the creation of a Climate Disclosure Task Force, coordinated through the G20, that could develop standards for companies to disclose their exposure to climate change risks. As the FSB proposal noted, meeting this objective will prove challenging, as there are more than 400 existing disclosure schemes that employ a range of different standards to measure climate change risks and corporate sustainability.

But the diversity of schemes involved also represents an opportunity to assess which practices are effective at improving corporate accountability for sustainability performance, as well as efficient at producing comparable reports that do not unfairly burden reporting organizations. Carney has recognized this opportunity by arguing that a "logical starting point is a co-ordinated assessment of what constitutes effective disclosure, by those who understand what is valuable and feasible" (ibid.).

Despite such ambition, policy research that explains how coordination could meet this objective is scarce. This brief will address this gap by identifying three key categories of governance practices involved in sustainability reporting that exhibit considerable diversity in their approach. It will examine how these divergent practices challenge end-users, and how the establishment of criteria that define effective and efficient reporting is a critical first step for the FSB and its Climate Disclosure Task Force.

Sustainability Reporting Governance Practices

Sustainability reporting has been conceptualized in many ways, as different actors interpret what information reports should contain. The Global Reporting Initiative (GRI), widely regarded as the leading international standard setter

in sustainability reporting, describes the sustainability report as: "A report published by a company or organization about the economic, environmental and social impacts caused by its everyday activities [which] also presents the organization's values and governance model, and demonstrates the link between its strategy and its commitment to a sustainable global economy" (GRI 2014).

The practice of issuing sustainability reports is a relatively new phenomenon, but there are three central governance practices that are emerging in sustainability reporting that deserve attention as sites for coordination among policy makers.

Report Format

Information in sustainability reports is communicated in three main formats. Firms have started to produce voluntary "stand-alone" sustainability reports that are separate from required financial reporting (Gray and Herremans 2012). At the same time, governments and stock exchanges have started to require the inclusion of sustainability disclosures — such as environmental liabilities, corporate governance structures and employee demographics — within existing financial reporting structures. These are often referred to as annual report disclosures. In addition, the integrated reporting movement, led by the International Integrated Reporting Council (IIRC), proposed the idea of an "integrated report" in 2010 (IIRC 2013). This type of report blends sustainability with material financial metrics, focusing on multi-dimensional value creation of a company through strategy, governance and performance disclosures.

Enforcement

A second governance practice involves the level of ambition in terms of enforcing disclosure. Although voluntary reporting is the most common approach, the level of ambition is quite low, since firms have the flexibility to determine if they will comply with the standards. Voluntary reporting tends to overemphasize positive results and does not present risks in a transparent way. Furthermore, leading performers often tend to report, while "laggards" avoid disclosure. In response to this concern, several sustainability reporting standard setters have emerged, including the Sustainability Accounting Standards Board (SASB) sector standards, the Climate Disclosure Standards Board's (CDSB's) Climate Change Reporting Framework (CCRF), the Carbon Disclosure Project disclosures and the GRI guidelines. Standards developed by these organizations attempt to improve enforcement by facilitating consultations among technical experts, including accounting experts, reporting organizations, regulators and civil society organizations. Participation in the development of the standards is designed to improve enforcement as organizations are given a stake in their development (Thistlethwaite 2015).

Sustainability reporting is also increasingly being implemented in national and international regulations. Since national and international financial reporting requirements are mandatory, the adoption of sustainability requirements offers the potential for more rigorous enforcement compared to voluntary regimes. These disclosure regulations can be embedded in government legislation, stock exchange listing requirements or securities reporting guidelines. Countries such as Denmark, France, South Africa and Sweden have begun to mandate reporting through legislation (United Nations Environment Programme [UNEP] and GRI 2013). The French government, for example, issued the Grenelle II Act in 2012 (amending an earlier act in 2008), which requires public companies to include information on the social and environmental impacts of their activities and sustainable development commitments in their annual report (Institut RSE Management 2012). Failure to provide adequate disclosure in France can result in financial sanctions for the firm. Denmark takes a slightly different approach by requiring that all firms operating in the country provide information in a report on their environmental accounts, such as water, waste and emissions. Other countries focus only on public companies by incorporating sustainability reporting requirements into stock exchange listing requirements, such as the Johannesburg Stock Exchange (JSE) in South Africa and the Shanghai Stock Exchange in China.

Disclosure Guidance

Sustainability reporting also adopts a range of different guidance principles that reporting organizations use to identify information that should be measured and communicated. Mainstream financial reporting standards typically follow either a principles-based or rules-based approach to disclosing information. Principles-based standards offer more flexibility by asking companies to interpret how to apply the principle and make independent judgments on whether the information disclosed meets the requirement. In contrast, rules-based approaches explicitly identify the information that must be disclosed. As a consequence of the uncertainty involved in measuring sustainability information, most reporting frameworks adopt a principles-based approach. For example, the King III Code adopted in South Africa classifies itself as a code of principles and practices, as opposed to a statutory requirement, but is mandated as a listing requirement for public companies on the JSE. King III argues that it is often not a case of whether to comply or not, but rather to consider how the principles and recommendations of the code can be applied by companies (ibid.). Although a principles-based approach aligns with the International Financial Reporting Standards, it contrasts with the US Securities and Exchange Commission's Generally Accepted Accounting Principles, which are rules-based.

Sustainability reporting frameworks also tend to adopt "comply or explain" standards to give companies flexibility in deciding

whether they would like to disclose certain information. Companies must either provide information for each standard, or explain why they did not disclose. Comply or explain reduces the cost of disclosure for firms that must use significant resources to expand accounting practices, but also encourages gradual adoption by giving the firm an opportunity to "learn by doing." The influence of the "comply or explain" in shaping disclosure is contingent on the accountability mechanism used for enforcement. Governments of countries such as France or Denmark require that disclosures be audited to ensure that firms use a sufficient explanation to justify why they are not complying. Voluntary standards rely on end-users, such as investors or civil society actors, to assess whether firm explanations for why they are not complying are sufficient. Although government-required audits are more rigorous in terms of accountability, "comply or explain" approaches lead to significant inconsistency between reports and standards.

The use of financial accounting guidance has also grown in popularity in recent years through initiatives such as the SASB and the CDSB. These standards adopt international accounting norms to inform the guidance firms use to disclose. In particular, they leverage the International Accounting Standards Board (IASB) characteristics of decision-useful information, which requires firms to disclose information that meets the needs of investors. Critics argue that this approach narrows the scope of the information disclosed to advance profit maximization at the expense of stakeholders seeking to hold firms accountable for their sustainability performance. Proponents counter by arguing that financial reporting principles are needed to improve efficiency and comparability, since most publicly listed firms have experience complying with this approach.

This assessment reveals three key areas of governance practice that shape sustainability reporting, including the report format, the level of enforcement and the disclosure guidance. The following section will examine some challenges that diversity among these practices creates for end-users as a justification for policy coordination.

Challenges in Sustainability Reporting Governance

The variation in sustainability reporting practices threatens the effectiveness of reporting in communicating information that can hold firms accountable for their sustainability performance; it also threatens efficiency by making disclosures difficult to compare.

Different report formats limit accountability and efficiency as stakeholders struggle to identify which report contains sustainability information. Information mandated (in some form) under government or stock exchange regulation is often embedded in financial documents that stakeholders seeking to improve accountability cannot understand or locate. Similarly, voluntary sustainability reporting standards often require sustainability data to be written in separate reports. If it is difficult to compare operational and performance data between companies, or if the data is not connected to financial performance, separate reports risk failing to influence stakeholders' interests, in particular those of shareholders. Differences in report formats between financial jurisdictions also limit comparability as sustainability information might be included in a separate report in Canada, but embedded in a lengthy integrated report in South Africa.

Report formats also tend to target one audience at the expense of another, which threatens their capacity to hold firms accountable to the plurality of interests among their stakeholders. In South Africa, for example, there is some confusion over the intended audience of the integrated report. The national body for integrated reporting, which wrote the King III Code of Corporate Governance, states that the integrated report is for all stakeholders. The IIRC, the international body that has developed international integrated reporting standards, states that the integrated report is primarily for providers of capital, or investors. This tension may explain why South African companies still often release voluntary stand-alone sustainability reports for stakeholders, despite being mandated to discuss sustainability information within their integrated report for investors. Voluntary disclosures in stand-alone reports are more likely to be useful for a broader group of stakeholders (such as civil society organizations), or for socially responsible investors who wish to find additional information beyond financial metrics. But these disclosures often discuss important financial information excluded from annual or integrated reporting that could be material for investors, such as greenhouse gas emissions or business continuity planning.

Varying levels of enforcement and disclosure guidance also limit the effectiveness and comparability of sustainability data as disclosures may not be the same across all companies in a given industry or sector. Firms can "forum-shop" the enforcement level or guidance that meets their interests. For example, in South Africa, Standard Bank Group focused on socio-economic indicators within its integrated report, such as employee retention and training, relying mostly on qualitative discussion. Meanwhile, First Rand Ltd, another South African bank, provided a few environmental and social indicators, such as energy efficiency and a workforce profile. Although enforcement and disclosure guidance is designed to promote flexibility and encourage the adoption of sustainability reporting, the diversity of practices currently employed by different schemes makes comparability of sustainability performance difficult.

These challenges justify a policy process that defines effective governance reporting practices for regulators, companies, investors and other stakeholders. Sustainability reporting has great potential due to its internal and external benefits for the reporting organization and interested stakeholders. Significant coordination is necessary, however, to identify practices that balance effectiveness (by holding firms accountable for their sustainability performance) and efficiency (by ensuring standards do not impose unfair reporting burdens).

Assessing the Effectiveness of Sustainability Reporting

The diversity of approaches involved in sustainability reporting justifies an assessment of which practices are effective and efficient at accurately communicating a firm's sustainability performance. Unfortunately, there is not much research to help address this problem (Hess and Dunfee 2007). Some studies have compared national reporting policies, and evaluated environmental and social disclosure quality at national levels (Brammer and Pavelin 2006; Langer 2006; Daub 2007; Clarkson et al. 2008; Morrow and Yow 2014; Barbu et al. 2014). There have also been studies that compared reports through the application of existing voluntary standards, and evaluating regional report quality (Morhardt, Baird and Freeman 2002; Amran, Lee and Devi 2014). However, there has been little work done on the evaluation of report quality that considers the wide array of practices involved. Although there are sustainability reporting criteria that have been developed, such as the KPMG Reporting Criteria and the UNEP/SustainAbility evaluation framework, many of these criteria have not addressed the variety of governance practices currently present in sustainability reporting. More specifically, existing reporting criteria often lack a clear implementation method, and have not been applied to evaluate either the form of reports (stand-alone, annual reports or integrated disclosures), the enforcement mechanisms (voluntary, legislation, stock-exchange) or disclosure guidance (principles-based versus rules-based, comply or explain).

Policy Recommendations

A set of criteria is required to define what is considered effective and efficient sustainability reporting in order to respond to the absence of an existing review on disclosure quality, and to address the policy mix in reporting.

Creating a set of criteria to evaluate reports could help identify how governance practices influence the quality and reliability of sustainability disclosure. These criteria could be developed by reviewing the content required within existing reporting standards, reviewing literature themes around assessing sustainability data, and communicating with professionals in the reporting field. Existing models that use qualities for evaluating reports, such as the UNEP/SustainAbility evaluation framework and the Reporting Criteria developed by KPMG, can be considered useful starting points for future evaluative criteria.

A plurality of stakeholders representing all interests that use sustainability reporting must be involved in developing the criteria.

In order to alleviate the current challenge of reports written for specific audiences, the criteria should evaluate not only the presence of financial data for investors, but also provide the qualitative context that general audiences can use for decision making. For example, the reporting format could be improved through an assessment of the accessibility and comprehensibility of the report content in terms of qualitative and quantitative measures for both investors and environmental organizations. Financial reporting standards tend to be developed in environments exclusive to actors outside of the financial sector. This model would create an accountability gap for environmental and civil society stakeholders if adopted by the FSB in the development of its standards. Initiatives such as the SASB, CDSB and IIRC have gone through several consultations on their standards, and offer important insights into the challenges different stakeholders experience in accessing and understanding report data. These organizations represent an important platform to build on for any coordination process.

Research on the evaluation of mainstream financial reporting strategies should be consulted to understand how policy makers assess different report formats and enforcement mechanisms.

Although sustainability reporting involves a much broader disclosure of information than does financial reporting, analysis on the effectiveness of existing mainstream approaches could offer insight into strategies that could be adopted in the sustainability reporting field. For example, the IASB has developed a set of principles that inform its standards, which have been adopted by more than 130 different governments. This model could be useful for the development of a similar set of sustainability reporting principles at the international level.

Conclusion

Sustainability reporting currently demonstrates a variety of complex governance practices with the use of different report formats, diverse levels of enforcement and various types of disclosure guidance. These practices provide important insight into the coordination necessary as part of an FSB process to standardize climate change risk disclosure. Indeed, the diversity in practices limits both the effectiveness of the standards in

holding firms accountable for their sustainability performance, as well as their efficiency, since disclosures are difficult to compare.

Despite this complexity, the range of governance practices already employed in sustainability reporting represents an opportunity to develop criteria that can assess both effectiveness and efficiency. These criteria must be applied to both regulated and non-regulated jurisdictions at the international level, and be inclusive of investor and non-financial stakeholder perspectives. The development of such criteria should constitute a core component of the FSB's new Climate Disclosure Task Force. Once criteria are created, reports employing different standards can be scored and assessed for their balance of effectiveness and efficiency through a transparent consultation involving existing standard setters and end-users.

Acronyms

CCRF	Climate Change Reporting Framework
CDSB	Climate Disclosure Standards Board
FSB	Financial Stability Board
G20	Group of Twenty
GRI	Global Reporting Initiative
IASB	International Accounting Standards Board
IIRC	International Integrated Reporting Council
JSE	Johannesburg Stock Exchange
SASB	Sustainability Accounting Standards Board
UNEP	United Nations Environment Programme

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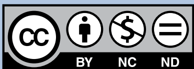

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